

Internal Revenue Service
memorandum

CC:TL-N-2708-88

Brl:MLTorri

date: MAR 10 1988

to: District Counsel, Cincinnati CC:CIN

from: Director, Tax Litigation Division CC:TL

subject: [REDACTED]

This is in response to your memorandum dated March 4, 1988, requesting technical advice with respect to the taxpayers named above, and confirms our telephone conferences of April 13, 1988, and May 5, 1988, during which we advised that a statutory notice of deficiency should be issued to the taxpayers.

ISSUE

Whether the taxpayers are entitled to a depreciation deduction on real estate that they held solely for resale. 0167-0200; 0167-0301; 0167-302; 0167-0303.

CONCLUSION

It continues to be the Service's position that if property is held exclusively for sale, it is not depreciable. Although in several cases the Tax Court has held that such property is "held for the production of income" within the meaning of I.R.C. §§ 167(a) and 212, the Service does not acquiesce in these decisions and continues to maintain its position that holding property exclusively for future sale does not qualify the property as property held for the production of income. As additional grounds for disallowing the deduction, property held for immediate resale has an indeterminate useful life and its salvage value is at least equal to the owner's cost basis in the property, and therefore, as a practical matter, the annual depreciation allowance cannot be computed.

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DISCUSSION

In [REDACTED], the taxpayers purchased a condominium unit in Florida, which they immediately listed for resale. The condominium was never offered for rent nor was it used for personal purposes. The property remained on the market until it was sold, at a gain, in [REDACTED]. On their income tax return for [REDACTED], the taxpayers claimed deductions for maintenance expenses and depreciation with respect to the condominium.

Upon audit, the examining agent proposed a disallowance of these deductions. The Cincinnati Appeals Office has requested technical advice from your office concerning whether it should sustain the disallowance of the depreciation expense in light of Newberry v. Commissioner, 4 CCH TCM 262 (1945), and Mitchell v. Commissioner, 47 T.C. 120 (1966), two cases which are factually similar to the instant case. The appeals officer has taken the position that the Service is unlikely to prevail if the depreciation deduction were disallowed, and in your memorandum you concur in that position. We disagree, and advise that a statutory notice should be issued.

Section 167(a) allows a depreciation deduction for the exhaustion, wear and tear (including obsolescence) of property used in a trade or business or held for the production of income. The purpose of the depreciation allowance is to permit the taxpayer to recover, tax-free, over the years of its use to the taxpayer, the capital which he has invested in the asset. Hibernia National Bank in New Orleans v. United States, 740 F.2d 382, 386 (5th Cir. 1984), citing H.R. Rep. No. 1337, 83d Cong., 2d Sess. at 22 (1954).

The Service takes the position that property held for sale does not constitute depreciable property. The rationale for this position was set forth in G.C.M. 34099, CC:I:I-3067 (April 16, 1969):

[T]he depreciation deduction is designed to allocate the cost of property having a useful life extending into more than one accounting period over the useful life of the property. The reason for such an allocation is to properly match in each accounting period a part of the cost of the property against the income generated by or attributable to the property in each of such periods. Thus, from a theoretical standpoint, depreciation allocation is appropriate only with respect to property that is anticipated to generate income in more than one accounting period. If property is held only for sale, generally, it is anticipated that the property will generate income only in one

accounting period, i.e., the period in which the property is sold. Accordingly, since cost should be properly matched against related income, and since in the case of property held only for sale the income arises only at the time of sale, it is obviously inappropriate to permit depreciation deductions in the accounting periods prior to the sale.

In Cooper v. Commissioner, 31 T.C. 1155 (1959), the Tax Court demonstrated its understanding of these principles when it stated:

This allowance is based on the fact that property used by a taxpayer in his trade or business, or held for the production of income, gradually approaches a point where its usefulness is exhausted. Thus, through annual depreciation, a taxpayer is allowed to recoup, as an operating expense for a given taxable period, that portion of the cost of the property estimated to have been consumed in producing the income earned during the period. However, it is well settled that property held for sale does not constitute depreciable property with the meaning of the statute.

31 T.C. at 1156-1157.

Nevertheless, subsequent to its decision in Cooper, the Tax Court has carved out an exception for improved real property held solely for sale. In a line of cases beginning with Mitchell v. Commissioner, 47 T.C. 120 (1966), the Tax Court concluded that property which is held for sale is "property held for the production of income" as that phrase is used in sections 162, 167(a) and 212(2), thus entitling taxpayers to deductions for depreciation and maintenance expenses. See also Newcombe v. Commissioner, 54 T.C. 1293 (1970); Scott v. Commissioner, T.C. Memo. 1963-172; Smith v. Commissioner, T.C. Memo. 1967-88, aff'd per curiam, 397 F.2d 804 (9th Cir. 1968). The court's reasoning is that section 212 refers to property held for the production of income, and "income" as defined by section 61 includes gains derived from dealings in property. Moreover, the legislative history of section 212 indicates that "income" within the meaning of that section is not limited to recurring income, but applies as well to gain from the disposition of property. Consequently, property which is being held to realize gain (in the form of appreciation) upon sale qualifies as property held for the production of income.

The essential issue presented in your memorandum is whether, in light of this line of cases, the Service should continue to disallow depreciation deductions claimed with respect to property

held by the taxpayer exclusively for resale. We believe that Service position dictates that such deductions must be disallowed. The Service disagrees with the Tax Court's reasoning, and in a series of Actions on Decision and Revised Actions on Decisions has indicated its nonacquiescence in this line of cases. See, e.g., George W. and Marie J. Mitchell, AOD (Sept. 2, 1970).

While it remains our primary position that property held solely for sale does not constitute property held for the production of income for depreciation purposes, alternative bases exist for disallowing the Depreciation allocation. These bases, the so-called "useful life" and "salvage value" arguments, are detailed in G.C.M. 34090 beginning at page 3 of that memorandum.

Depreciation is based on estimates as to useful life and salvage value. Massey Motors, Inc. v. United States, 364 U.S. 92 (1960); Hertz Corp. v. United States, 364 U.S. 122 (1960). As a practical matter, a taxpayer who holds property solely for sale cannot calculate the annual depreciation allowance because he cannot determine these two elements of the equation.

Treas. Reg. § 1.167(a)-1(b) defines "useful life" as the period over which the asset may reasonably be expected to be useful to the taxpayer in the production of his income. Several decisions of the Supreme Court clearly establish that "useful life" for depreciation purposes means the useful life of the property to the taxpayer in his trade or business or income-producing activity, and not necessarily the useful life inherent in the asset. See, e.g., Massey Motors, Inc. v. United States, *supra*, 364 U.S. at 101. Since the taxpayers are holding their property for immediate resale, a determination of its estimated useful life to the taxpayers would be based on pure conjecture, for it requires them to estimate the length of time anticipated to sell the property. This determination is made at the time of acquisition, and not by a hindsight view.

"Salvage value" is the amount (determined at the time of acquisition) which is estimated will be realized upon sale or other disposition of the asset when the taxpayer's use of it in his trade or business or in the production of income. Treas. Reg. § 1.167(a)-1(e). Salvage value is the actual resale price which the taxpayer can expect to realize upon disposition of the asset. Hibernia National Bank, *supra*, 740 F.2d at 386. With respect to property which is purchased and immediately held for resale, no depreciation is allowable because depreciation may only be taken on the adjusted basis, i.e., the extent to which cost basis exceeds estimated salvage value. In the case of property held exclusively for appreciation, this estimation will necessarily be zero since, by holding the property for the production of income (appreciation), the taxpayers expect at the time of acquisition that the actual sale price will be greater than their cost.

Hence, they cannot establish the depreciable basis of the property.

The Tax Court has intimated that it could be persuaded by these arguments if presented with the right case. In Sherlock v. Commissioner, T.C. Memo. 1972-97, the court stated, "While these arguments have substantial appeal when the residence is question is held for immediate sale only, they are not appropriate to the present situation. The property in the instant case was held for sale or rent." (Citation omitted; emphasis in original). The useful life and salvage value analyses were also mentioned favorably in Newbre v. Commissioner, T.C. Memo. 1971-165. Because the taxpayers referenced above purchased their condominium for the exclusive purpose of offering it for immediate resale, and did not it hold the property for both sale or rent, we believe this case presents the right set of circumstances. Additionally, this case is favorable because, unlike Newberry and Mitchell, the property was not converted from another purpose before being offered for sale. Thus, this case offers the court an opportunity to squarely address the useful life and salvage value arguments, and for this reason we disagree that the government would prevail if the depreciation deduction were disallowed.

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